Pricing nontraditional products and services

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Most agricultural commodities are sold in markets where price has been established by broad market forces. While producers in such markets can't set price, they usually have a ready market for their entire production. Sellers in commodity markets are basically price takers; they have to accept the market price. Price risk is incurred because the available price (over which you have no control) may be below the cost of production. Thus, producers of traditional agricultural commodities generally don't deal with product pricing.

On the other hand, producers of nontraditional or alternative agricultural products (and/or services)[1] must often establish a price. Since such products generally don't have a recognizable market, there is uncertainty about quantities that can be sold. The basic concept of demand suggests a smaller quantity will be sold at a higher price than at a lower price. Setting the price too high means revenues may be reduced because limited quantities are sold. Alternatively, if the price is set too low, the product sells quickly and potential profits are lost.

The purpose of this article is to suggest some alternative pricing procedures in markets where you are a price maker — able to set the price of your product — rather than a price taker. Major factors influencing the pricing decision include cost of production, competition, and value of the product to buyers. These factors are somewhat interrelated, but can be used to describe alternative pricing procedures. These pricing methods increase in complexity as you move through the list. Information developed for the less complex procedures is also useful for the more complex cost-based pricing

Cost-based pricing

The initial focus of the pricing decision should relate to the cost of production. This is generally the easiest to evaluate and requires information that is known (or should be known) by you. Examples of cost-based pricing methods include the following:

Markup pricing

The cost of goods sold plus a percentage markup is markup pricing. The per-unit cost of production ((variable cost + fixed cost) ÷ output) is calculated, and a percentage increase is added to generate a profit.[2] This method provides a simple pricing procedure, especially when multiple products are being sold. As with any cost-based pricing method, the key is to include all relevant costs of production, including noncash costs. Your own labor and management expertise, opportunity cost of owned capital, land costs, etc., are easy to overlook if they do not involve an actual out-of-pocket expense.

Planned-profit pricing

Planned-profit pricing is determination of the price level that generates the revenue needed to earn a

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[1]Throughout this article, the term "product" will be used in discussing the pricing process. However, the same concepts can be used for products, services, or a combination of products and services. Thus the term "product" is used to represent all three possibilities.

[2]Variable costs are those costs that change as the level of production changes. Examples include seed, fertilizer, and production labor. Variable costs are sometimes called direct costs. Fixed costs are those costs that remain unchanged regardless of the level of production. Examples include depreciation on buildings or equipment and property taxes. Fixed costs are sometimes called overhead.

designated total profit. Profit is equal to total revenue (TR) minus total cost (TC), or:

Profit = (price x quantity) - (total variable cost + fixed cost).

Planned profit pricing assumes some quantity of output will be sold and sets a price at the level required to reach the planned profit level. The formula can be written as:

Price = (total variable cost + fixed cost + profit) ÷ quantity.

Cost-plus pricing

The cost of production plus a designated percentage is cost-plus pricing. This method is useful in situations where costs are not known in advance. An example would be custom orders in the initial stages of developing a new product. The price quoted to the buyer is "cost plus" rather than a specific price, and the final price will be established after completion of the project when all costs are known.

The advantages to cost-based pricing are that these methods should be relatively easy to implement and use information that is already required to operate the business. Disadvantages are that cost-based pricing ignores the competition and doesn't consider what the product is worth to the buyer. A pricing procedure that is not responsive to changes in the market may work initially, but can be a significant obstacle to long-run success.

Competition-based pricing

Understanding the competition and implementing a pricing strategy based upon the nature of the competition involves determining exactly what you are selling, recognizing substitutes, identifying existing firms in your relevant market, and analyzing how other firms in the market compete. Examples of competition-based pricing methods include the following:

Market pricing

Pricing at the same level as the competition is market pricing. Assess how your product relates to a competitive product and set your price at a comparable level. This procedure is easy for similar products but becomes more difficult for products that differ in appearance, quality, packaging, etc.

Market-penetration pricing

Market-penetration pricing is setting price at a level required to penetrate the markets. This practice generally involves pricing below the competition to gain market entry. The purpose is to acquaint buyers with your product. The easiest way to generate buyer attention is with some form of discount price.

Market-share pricing

Establishing a price necessary to obtain a predetermined market share is market-share pricing. This procedure provides a specific and measurable goal to use in the pricing decision after market penetration has been achieved. Additionally, market share is a commonly used measure of relative importance in the market place and can increase firm recognition.

Advantages of competition-based pricing methods are that characteristics of the market are being recognized and incorporated into the pricing decision, as well as other management decisions. Disadvantages are that production costs are not explicitly included and have the potential of being ignored, more information external to the firm is required, and retaliation by competitors is a likely consequence.

Demand-based pricing

Assessing the value of your product to the buyer involves an effort to identify and analyze important characteristics of existing or potential customers (demand analysis). Examples of demand-based pricing methods include the following:

Image pricing

Using price to complement the product image you wish to portray to the buyer is image pricing. A higher price tends to support the image of quality or prestige, whereas a lower price tends to suggest a bargain or that a product is of lower quality. For a product that typically sells in the range of $2.00 to $3.00, a price of 99 cents reflects a bargain image. Conversely, a price of $4.00 supports the image of quality or prestige. The secret behind image pricing is for the product's price to send a message to the buyer consistent with the image you are trying to portray.

Promotional pricing

In promotional pricing, price is used to attract the customers' attention or support other promotional efforts. Imagination is the key to this pricing strategy. Examples might be loss leaders (pricing commonly purchased items below cost to attract customer attention), merchandise close outs, inventory reduction, holiday specials, etc.

Segmentation pricing

Segmentation pricing is dividing the market into logical groups and pricing to appeal to each group. As knowledge about the market increases, your ability to logically group the market into segments should increase. Examples of groupings might be location, time of the year, income levels, tourists, product utilization, ethnic groups, level of competition, etc.

Volume pricing

Using volume discounts to increase sales revenue is volume pricing. This process can be used to reflect cost savings (that is, it may be cheaper to provide the product in large volume) or used to increase your sales level. Examples might be 59 cents each or 2 for $1.00, or 10 percent off for purchases of 10 or more.

Product-bundle pricing

Combining several products and offering the entire set at a special price is product-bundle pricing. This procedure can be used to sell slow-moving merchandise or can actually be used to design a more desirable product. Creating a merchandise bundle that sells for less than the sum of the costs of each item (that is, a bargain) may be an innovative way to move merchandise that isn't selling on its own. From another perspective, designing a comprehensive package that covers all of the costs of a family's recreational experience adds a significant service to someone trying to budget the cost of a family vacation.

Advantages of demand-based pricing are that you can use the pricing process to better understand customers and better identify additional marketing opportunities. Disadvantages are that costs of production and the nature of competition may be ignored, and the necessary information is often difficult to obtain.

Summary

For producers of established agricultural commodities, pricing is probably a new experience because the marketplace has traditionally provided that function. As a result, pricing may be an uncomfortable management activity at first. Since knowledge of costs is an important initial undertaking and these costs can be used in product pricing, cost-based pricing may be the best place to start. However, increased understanding of your competition and your customers is what marketing is all about. Efforts to improve knowledge about your customer base and the firms that are competing in your market will have long-term payoffs.

Prices will likely need to be adjusted over time for many reasons: the cost of inputs may increase or decrease, products go through a natural life cycle from being "new" to being "mature," customer demand is altered by social and economic forces, and the nature of competition changes. It's important to recognize pricing decisions are an on-going part of effective management. However, rapid and constant price changes can be annoying to customers. Once a price strategy is developed, stick with the procedure long enough to effectively determine its impact before making a significant change.

Imagination is an important component of any pricing program. Don't let your imagination be limited by the examples presented here. No pricing strategy is "best" for all sets of conditions. Also, a successful pricing program can have characteristics associated with several of the strategies outlined above. Experimenting with different pricing strategies may be necessary to determine the ideal pricing method for a particular situation. The idea is to learn as much as possible about your market. Experience is an excellent teacher; as you gain pricing experience, be sure to maintain excellent records so you can review which strategies are most effective and evaluate specific information about your customers.

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